IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

COMPANY APPLICATION No 261 of 1994
in
COMPANY PETITIONNo 157 of 1986

For Approval and Signature:

Hon'ble MR.JUSTICE M.S.SHAH

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : YES

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the Civil Judge? : NO

O.L. OF ARYODAYA GNG. & MFG. MILLS LTD.

Versus

GULABCHAND CHANDALIA

Appearance:

1. COMPANY APPLICATION No. 261 of 1994
MR NAVIN K PAHWA for the Official Liquidator
MR MUKESH A PATEL for Petitioner No. 1
MR GN SHAH for Respondents No. 1-3

CORAM : MR.JUSTICE M.S.SHAH

Date of decision: 07/02/2002

ORAL JUDGEMENT

This is an application filed by the Official Liquidator of Aryodaya Ginning and Manufacturing Company Limited (in liquidation) under Section 543 of the

Companies Act, 1956, ("the Act", for short) by which the Official Liquidator has prayed for a declaration that the respondents nos.1 to 3 herein who were Directors of the company in liquidation at the relevant time had misapplied, retained and became liable and accountable for the monies or properties of the company and that they were guilty of misfeasance, breach of trust, breach of duty, gross negligence in discharging their duties and managing the affairs of the company and for various other ancillary reliefs.

2 The above-named company was ordered to be wound up as per this Court's order dated 27.10.1989. The Official Liquidator attached to this Court was appointed as its Official Liquidator, who has filed the present application. As per this Court's directions, the Official Liquidator appointed M/s Vibhakar J Trivedi & Co., Chartered Accountants, for the purpose of investigating the books of accounts of the company. After scrutiny of books of accounts and available records the Chartered Accountant submitted their investigation report mainly pointing out as under:-

(i) The Directors and officers of the company had not filed annual audited accounts for the year 1986-87 and annual returns within the statutory limits and therefore the penalties etc. which may be levied by the Registrar of Companies, Courts etc. within the purview of Section 543 of the Companies Act, 1956.

(ii) From the scrutiny of accounts for the years 1984-85 to 1986-87 it appears that the management had shown suppressed losses and inflated assets in the past as is evident from the remarks of the statutory auditors in their reports for the past four years. The said details are referred hereinafter. They mainly pertain to calculation of depreciation, contrary to the accounting practice recommended by the Institute of Chartered Accountants of India and they also pertain to payment of interest on borrowings and the interest payable on term loans for acquisition of fixed assets had been capitalised up to the date of installation with effect from 1.4.1982. The third observation against the ex directors is that the liability of gratuity to the employees who left services during the year amounting to Rs.29,46,873 was not provided and that it reduced the loss in that year to that extent. According to the Chartered Accountant

the net effect of the above policies which are contrary to accounting practices for the relevant years resulted into understatement of loss to the following extent:-

YEAR	UNDERSTATED LOSS
(1) 1983-84	Rs.20,02,385
(2) 1984-85	Rs.17,00,481
(3) 1985-86	Rs.13,06,747
(4) 1986-87	Rs. 8,67,410

The Auditors further stated in their report that the Company continued to incur heavy losses for the period between 1.4.1987 and 27.10.1989 (for which accounts are not audited) to the extent of Rs.3.36 crores and the accumulated losses as on 27.10.1989 when the statement of affairs was filed was Rs.6,39,37,716.

In short, the allegation against the ex-Directors is that they had shown better financial results than actual financial position warranted and this was done by suppressing losses and the creditors were accordingly misled to lend further credits and depositors were misled to renew their deposits. Accordingly, the Auditors quantified the liability of the respondents that they had committed misfeasance of Rs.5,26,84,575 plus Rs.43,91,675 totalling to Rs.5,70,76,248. These figures were disclosed in the points of claim.

3 The respondents filed their points of defence under Rules 261 and 260 of the Companies Court Rules, 1959 making the following broad submissions:-

(i) The application did not contain a detailed narration of the specific acts of commission or omission on the part of the each Director quantifying the loss of the company.

(ii) It is not even the case of the applicant that the respondents or any of them had misapplied or retained any money/property of the company.

(iii) In order that the misconduct may amount to

misfeasance it must be alleged and proved that the alleged misconduct was wilful or amounted to misfeasance culpable negligence.

(iv) The respondents were ordinary Directors of the Company whose duties were of a intermediatory nature performed at periodical Board Meetings. The Company was a professionally managed company and the Board of Directors had from time to time employed competent senior officers including General Managers and other Managers for various departments of Textile Mills of the Company. None of the respondents was the Managing Director of the Company.

4 On the merits of the charge levelled against them the respondents have contended that the Statutory Auditors of the company were a well known and reputed firm of Ahmedabad with more than 60 years of professional standing and they had followed the standards of accounting of Institute of Chartered Accountants of India while auditing account books of the company. The said accounting standards were circulated by the company to all the members of the company along with the printed balance sheet and profit and loss account for the year 1983-84, 1984-85 and 1985-86. The explanation given by the Directors in respect of the qualification of the Auditors and the notes for the relevant years were unanimously approved and accepted by the members of the company including writing back of provision for multiple shift allowance of previous years and non provision for interest on borrowings for fixed assets by capitalising the same. The respondents also state that they had in their Directors' Report referred to the legal opinion obtained by them for adopting the aforesaid accounting practices and the said opinion dated 31.7.1984 of Mr B.J. Divan is produced at Annexure-A to the points of defence. It is submitted that the Directors had obtained competent legal advice and relying upon the same the respondents had acted honestly and with bona fides and in the interest of the company. It is also contended that there cannot be any misfeasance or misapplication of the funds or retention of Company's property when full disclosure is made to all the members who have in their collective wisdom approved and accepted the same at a properly convened General Meeting. The inferences drawn in the report of M/s Vibhakar J. Trivedi & Co. are controverted and contested. It is submitted that the report does not state how and in what manner the writing back off the provisions of multiple shift allowance and capitalization of interest in the books of the accounts

of the Company from the previous year can ever constitute misapplication of the funds or retention of the funds of the Company by the respondents or breach of trust by the respondents when all the facts were disclosed by all the Directors who had approved the accounts and thereafter the accounts were approved by the members at the Annual General Meeting without any objection ever having been raised to the method adopted by the company.

As regards non-filing/late filing of the annual audited accounts for the year 1986-87, the reasons are given in para 8 of the points of defence and it is submitted that in any case the company has not been prosecuted by the Registrar of Companies and that no order for payment of any penalty is passed; in any case any such order cannot be regarded as misconduct or misfeasance on the part of the respondents.

5. The written submissions dated 19.2.2001 have also been filed by the learned counsel on behalf of the Official Liquidator and the written submissions dated 20.2.2001 have been filed on behalf of the respondents.

6 At the hearing of this application Mr Navin Pahwa, learned counsel for the Official Liquidator, has reiterated the averments and submissions made in the points of claim and also in the written submissions. It is submitted that by suppressing losses and inflating the assets of the company the respondents had induced the creditors to give more loans and had misled the depositors for renewing the deposits. It is submitted that depreciation was not worked out as per the guidelines issued by the Institute of Chartered Accountants and that therefore, there was a clear breach of duty Ratification of any illegal act of the Directors by the shareholders would not make the action legal and, therefore, the respondents are guilty of misfeasance and breach of trust and are liable to make good the loss.

It is also submitted by Mr Pahwa that misfeasance proceedings are not criminal in nature and that it is not necessary for the applicant to prove mens rea on the part of the ex Directors.

7 On the other hand, Mr G.N. Shah, learned counsel for the respondents, has vehemently opposed the application and apart from reiterating the averments and submissions made in the points of reply and written submissions, has relied on several authorities in support of his submission that the misfeasance proceedings are quasi-criminal in nature and that the applicant has

neither given the specific and exact details of any alleged act of commission and omission on the part of each individual Director nor has the applicant made out any case that following accounting method in question would amount to misfeasance or breach of trust.

8 Before adverting to the allegations made against the respondents in the present case, it is necessary to make a brief reference to the principles enunciated by the Apex Court in the matter of misfeasance proceedings. Section 235 of the Companies Act (old Act) contained provisions analogous to Section 543 of the Companies Act, 1956. In P.K. Nedungadi v. The Malayalee Bank Limited (in liquidation) AIR 1971 SC 829, interpreting similar provisions of Section 235 of the old Act, the Apex Court observed as under:-

> "Under Section 235 of the Indian Companies Act, 1913 which was in force at the material time the Court has been given the power to assess damages against the delinquent Directors, etc. If the money or the property of the Company has been misapplied or there has been misfeasance or breach of trust in relation to the company by a Director, an officer or other persons mentioned in the section the Court, after examining the matter, can compel him to repay or restore the property with interest at such rate as the court may think fit or to contribute such sums to the assets of the Company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Court thinks fit. It has been expressly declared that the section shall apply notwithstanding that the offence is one for which the offender may be criminally responsible."
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> (emphasis supplied)

In OFFICIAL LIQUIDATOR V. RAGHAVA DESIKACHAR AIR 1974 SC 2069 the Supreme Court has observed as under:-

> "... It may be mentioned that misfeasance action against the Directors is a serious charge. It is a charge of misconduct or misappropriation or breach of trust. For this reason the application should contain a detailed narration of the specific acts of commission and omission on the part of each Director quantifying the loss to the

Company arising out of such acts or omissions. The burden of proving misfeasance or nonfeasance rests on the Official Liquidator. The Official Liquidator, it may be mentioned, merely relied upon the evidence recorded in public examination of the Directors and on a few documents tendered in evidence. At the stage of public examination there was no charge of misfeasance against the Directors and they were not in a position to know what would be the grounds that would be alleged against them for recovering any amounts, for the loss said to have been caused to the Company by reason of such misfeasance."

(emphasis supplied)

In OFFICIAL LIQUIDATOR, SUPREME BANK LIMITED V. P.A. TENDOLKAR 43 Comp. Cases 382 = AIR 1973 SC 1104 the Court laid down the following principles in para 40 of the judgment :-

"40. It is certainly a question of fact, to be determined upon the evidence in each case, whether a Director, alleged to be liable for misfeasance, had acted reasonably as well as honestly and with due diligence, so that he could not be held liable for conniving at fraud and misappropriation which takes place. A Director may be shown to be so placed and to have been so closely and so long associated personally with the management of the Company that he will be deemed to be not merely cognizant of but liable for fraud in the conduct of the business of a Company even though no specific act of dishonesty is proved against him personally. He cannot shut his eyes to what must be obvious to everyone who examines the affairs of the Company even superficially. If he does so he could be held liable for dereliction of duties undertaken by him and compelled to make good the losses incurred by the Company due to his neglect even if he is not shown to be guilty of participating in the commission of fraud. It is enough if his negligence is of such a character as to enable frauds to be committed and losses thereby incurred by the Company."

9 The aforesaid decisions as well as various other decisions referred to by A. Ramaiya in the Guide to Companies Act (2001 - 15th Edition page 3766 to 3773) indicate that the liability which is enforced under this Section is a liability in the nature of tort or a

liability in the nature of quasi-criminality and is founded with principle that the Director who has caused loss to the company by an act which amounts to misappropriation, breach of trust, misapplication or retention should make good the loss. It provides a summary remedy to determine the amount payable by such Director. The Section thus provides a speedy remedy of payment of compensation to the company in respect of loss occasioned to the company by the misfeasance of the delinquent Director. A misfeasance claim against the company officers is capable of covering the full range of duties owed by a director to a company and is not restricted to ethical or fiduciary duties. [Westlowe Storage & Distribution Ltd., Re, (2000) 2 BCLC 590 (Ch.D.)]. Only misfeasance resulting in loss to the company will come under the Section. Mere negligence or neglect of duty unless loss has resulted by reason of it, will not create any liability.

10 A bare perusal of the points of claim made by the Official Liquidator on the basis of the Chartered Accountant's report indicate that the case against the respondents is that by following erroneous accounting practices the losses were suppressed and the value of the fixed assets was enhanced. However, it is not the case of the Official Liquidator that on account of such accounting practices any loss was caused to the company or that the accounting practices in question were followed in order to enable the respondents to misappropriate or misapply the company's moneys or properties or in order to enable them to retain the company's moneys or properties. The only allegation made is that by suppressing losses and enhancing the assets of the company the company could get more advances from the creditors and renewal of the deposits of the depositors. The Auditors, however, did not address themselves to the crucial question whether the respondents had misapplied the funds or properties of the company or that the respondents had retained or misappropriated the funds of the company. In fact, the report of the Chartered Accountants does not show, much less quantify, whether any actual loss was caused to the company on account of the accounting practices adopted by the company.

11 As per the settled legal principles enunciated by the Apex Court and referred to hereinabove, the misfeasance proceedings are to be conducted in order to make the responsible Director to compensate the company for the loss suffered by the company by the acts and omissions of the Director which acts or omissions should constitute breach of trust, misappropriation,

misapplication or retention of the Company's monies or properties by the concerned Director.

12 In the first place the Chartered Accountants' report does not indicate as to what loss has been occasioned by the acts/omissions in question. In that view of the matter it may not be necessary to go to the next stage of enquiry whether such loss was occasioned on account of any act of commission or omission on the part of the ex-Directors. Mere mistakes or error in adopting accounting practices cannot amount to misfeasance unless it resulted into any loss to the company or any undue gain to the Directors or to other persons.

13 In CHAMUNDI CHEMICALS AND FERTILIZERS LTD. V. M.C.CHERIAN AND OTHERS. 77 CC 857 Hon'ble Mr Justice K. Jagannatha Shetty speaking for the Karnataka High Court held thus:

> "The decision of the board of directors to charge interest on sums advanced for installation of machinery, not from the date of advance, but from a later date when the company decided not to have the machinery installed, the decision of the board to write off certain sums due from employees, and a certain sum advanced for supply of machinery, were all decisions taken by the board of directors of the company in the interest of the company. There was no specific charge against any individual director, nor was there a charge that the directors misappropriated the sums in question for personal benefit. The loss alleged to have been sustained by the company was speculative rather than real and too remote, and it could not be said that the company had sustained loss as a direct consequence. Therefore, the directors were not liable for any misfeasance or misappropriation or breach of trust under section 543 of the Companies Act, 1956."

It is thus clear that merely charging less interest or writing off certain sums due from the employees or to advance sum for supply of machinery may be decisions which may ultimately turn out to the monetary disadvantage of the company but it must be shown in the misfeasance proceedings that the company had sustained a loss as a direct consequence of the breach of duty of the Directors.

14 In Re. Thomas Gerrand & Son Ltd. (1968) Chancery Division 455 the dividends were paid otherwise than out of the company's distributable profits. The accounts had been falsified by the Managing Director to show larger profits than in fact made. Therefore, the company's auditors were held to be liable under misfeasance proceedings because they failed to audit the accounts properly. Thus, the liability was fastened not just for falsification of the accounts but because by falsification of the accounts the company's distributable profits were shown larger than they were and dividends so paid to the Directors in their capacity as shareholders resulted into undue gain to them.

15 In view of the aforesaid principles, it is clear that in the facts of the instant case the Official Liquidator has not made out any case that on account of any act or omission on the part of the Ex-Directors of the company had resulted into loss to the company. In this view of the matter, no further enquiry is required to be made and the application deserves to be dismissed.

16 The learned counsel for the Official Liquidator, however, submitted that even if the case does not fall under Section 543 of the Act, it is certainly covered by the provisions of Sections 540(a) and 542(1) of the Act, which read as under :-

"Penalty for frauds by officers

540. If any person, being at the time of the commission of the alleged offence an officer of a company which is subsequently ordered to be wound up by the Court or which subsequently passes a resolution for voluntary winding up,-

(a) has, by false pretences or by means of any other fraud, induced any person to give credit to the Company; or

(b) ... ...

(c) ... ...

he shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine.

Liability for fraudulent conduct of business

542(1). If in the course of the winding up of a company, it appears that any business of the company has been carried on, with intent to defraud creditors of the company or any other persons, or for any fraudulent purpose, the Court on the application of the Official Liquidator, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.

On the hearing of an application under this sub-section the Official Liquidator or the liquidator, as the case may be, may himself give evidence or call witnesses."

Sub-section (3) further provides for prosecution of those persons who were party to the fraudulent conduct referred to in sub-section (1) of Section 542 of the Act with liability to imprisonment upto 2 years and/or fine of Rs.2500.

The learned counsel, therefore, submitted that in view of the report of the Chartered Accountant that the Directors had understated the losses and overstated the assets and thereby, misled the creditors into giving credit to the Company and led the depositors into renewing the deposits, the provisions of Sections 540(a) and 542(1) were fully applicable.

17 It is important to bear in mind the basic distinction between the provisions of Sections 540 to 542 on the one hand and those of Section 543 on the other hand. While the former deal with the wrong done to the creditors and others and require mens rea, the latter only deal with the loss caused to the Company on account of misfeasance of the Directors, which would include even culpable negligence.

It is true that the thrust of the report of the Chartered Accountant is that by understating the loss and by overstatement of the value of the net assets, the Ex-Directors of the Company induced the creditors to advance monies to the Company and also renew their deposits. Prima facie this allegation could be subject

matter of the proceedings under Sections 540(a) and 542(1) of the Act.

However, this would require the Official Liquidator to show that Ex-Directors had by fraudulent means induced any person to give credit to the Company for the purpose of its business being carried or for any other fraudulent purpose. In order to prove this charge, the Official Liquidator would be required to bring materials on record to bring the case within the four corners of Sections 540(a) and 542(1) of the Act. The contents of the present application are for relief under Section 543 of the Act and the applicant has not laid any foundation or led evidence for invocation of Sections 540(a) and 542(1) of the Act and hence the Court does not propose to entertain the submissions made by Mr Pahwa for invocation of Sections 540(a) and 542(1) of the Act.

18 The Company Application is accordingly dismissed. There shall be no order as to costs.

(M.S. Shah, J.)

(mohd)